ECONOMIC OUTLOOK

REGIONS

October 2020

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The Not So Curious Case Of The Missing Houses . . .

If all one had to go by were the accounts of home sales over the past few months, they might be excused for thinking that the for-sale segment of the housing market has been jolted awake from a deep and prolonged sleep. Having been liberated from physical offices and now free to work from anywhere, Americans have fled en masse to the exurbs and, fueled by extraordinarily low mortgage interest rates, are buying every existing home that is for sale and enlisting every available homebuilder to slap up as many new home/office/classroom combos as can possibly be slapped up. So, in a matter of a few short months, we've gone from no construction and no sales to suddenly insatiable demand turning a dormant market into a "sizzling" market, all in the midst of a pandemic that has yet to run its course.

Okay, that's not really true, but, again, if all one had to go on were the often-breathless accounts of recent home sales, one might believe that to be the case. It does, though, raise an interesting question, which is that, if everyone flees the core urban areas to the exurbs, doesn't that make the exurbs the new urban cores, just far away from the old urban cores? (Side note: if you don't know where the exurbs are, head out to the suburbs, then keep going.) There is no denying that some of the changes wrought by the pandemic and the efforts to stem its spread – changing work arrangements, a push toward areas with lower population/housing densities, lower mortgage interest rates – have bolstered demand for home purchases, particularly for homes away from core urban areas. There is, however, a difference between being an agent of change and an accelerant of change.

The reality is that the patterns cited above – the changing nature of work arrangements and the push to the exurbs – were in place long before the pandemic struck, and mortgage interest rates were already notably low. So, while the pandemic has certainly helped to intensify these patterns, they're not new. Nor are the patterns in sales of new and existing homes. Construction and sales of new single family homes have been on a slow but steady upward march for the past several years. Sure, "slow but steady" doesn't tend to generate breathless accounts of monthly activity, so while the market for new homes has by no means been in a slumber, many analysts were apparently lulled to sleep by the slow but steady increases in construction and sales. Our view has all along been that "slow but steady" reflected supply constraints rather than middling demand. We're not exactly sure what year it was, but it was years ago when we first said that builders could easily sell more homes if only they could build more homes.

The story has been similar for existing home sales, with a key difference being that what had been a steady increase in sales was disrupted by even more pressing inventory constraints. Those "sizzling'" existing home sales in July and August to a large extent reflected payback for contract signings and closings that had been put off due to pandemic-related shutdowns in prior months, meaning it would be a mistake to assume that the July and August sales figures are setting a new trend rate for existing home sales.

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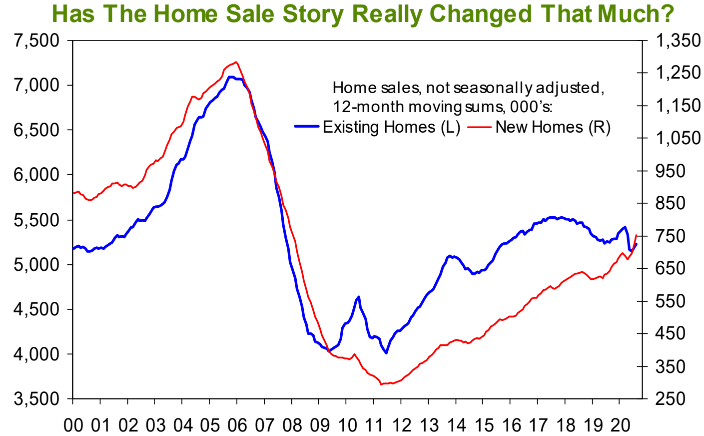
Has The Home Sale Story Really Changed That Much?



Source: U.S. Census Bureau; National Association of Realtors; Regions Economics Division

While growth in demand for home purchases has shifted into a higher gear over the past few months, this has helped cast an even brighter light on what was already an inadequate supply of homes for sale, even if many analysts seem not to have noticed prior to this point. One manifestation has been a faster rate of growth in home prices. Keep in mind that one advantage homebuilders have is that sales can be booked prior to construction having been started. As such, growing backlogs of unfilled orders can help mask over the lack of physical homes for sale. This is worth noting, given spec inventories of new homes for sale fell to a more than three-year low in August.

As our regular readers know, lean inventories acting as a drag on home sales is not a new topic for us, but instead is something we have been focused on for the past several years and which has shaped our forecasts of home sales during this period. As such, we won't go into great detail here, but with the Census Bureau's release of the 2019 *American Community Survey* (ACS) we do want to update a couple of factors we've pointed to as weighing on listings of existing homes for sale over the past several years. For those not familiar, the *American Community Survey* (ACS) is an annual survey that in many ways has come to serve as a more timely substitute for the decennial Census in providing updated data on a range of topics, including demographics and housing.

One factor we've pointed to as helping hold down the turnover of existing homes is the aging of the nation's homeowners. Based on the ACS data, as of 2019, in 55.5 percent of all owner occupied housing units the primary householder was at least 55 years old.

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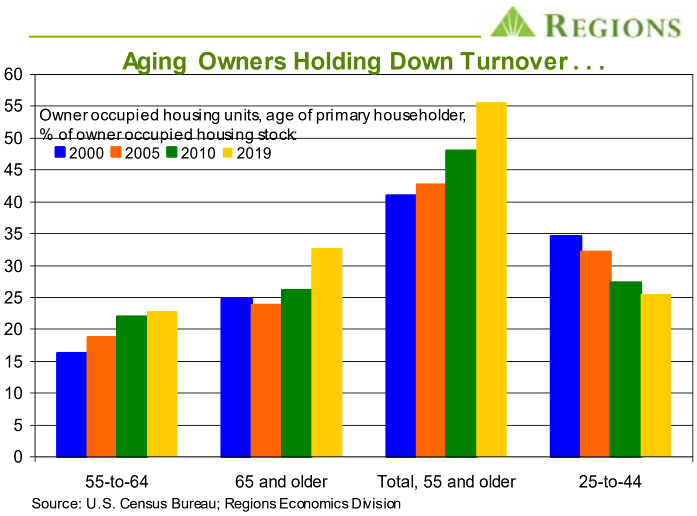
As seen in the chart below, this share has been rising over the past 20 years, and while to some degree this simply reflects the aging of the population, there are reasons to think housing turnover amongst this age cohort has slowed, thus holding down the number of existing homes for sale.

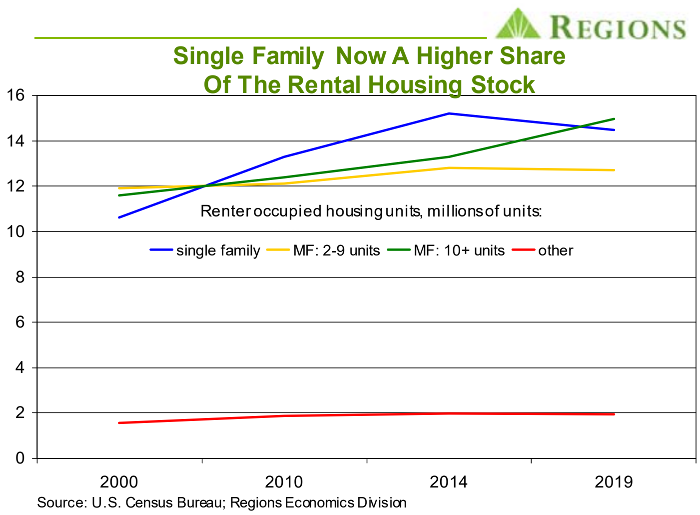


Data on labor force participation shows the participation rate amongst those aged 55-and-above has risen over the past several years, with participation rates in the 55-to-64 year-old and the 65-and-above age cohorts well above the rates that prevailed prior to the 2007-09 recession. It could be that significant numbers of those in these age cohorts have yet to fully recover from the steep declines in housing equity and equity prices that accompanied the 2007-09 recession, particularly those who were wary of venturing back into equities, and, as such, are working longer than they had planned to. The dramatic declines in equity prices seen earlier this year could have had that same effect, at least on those who sold at or near the bottom and hence missed the subsequent rapid rebound. For whatever reason, that more members of these age cohorts continue to work is a sign that other life changes, such as either downsizing into a smaller single family home or moving into a community living setting, have also been delayed, which we think is playing a role in holding down inventories of existing homes for sale.

Again, this is not a new topic, and we've used the above chart with previous releases of the ACS data. Indeed, we recall one discussion of this topic in pre-pandemic times in which one of the participants pointed to this very pattern then added that, even should members of these age cohorts begin to leave their homes, that so many of these homes were in outlying suburban areas meant they would be of no interest to millennials looking to buy their first home. As such, there would be little relief on the inventory front. Sure, that was ridiculous at the time, as is any instance of someone attempting to make broad generalizations that are supposed to apply to each and every one of over 70 million members of a certain age cohort.

With homes in outlying areas now in even more demand, we still think the issue is not where these homes are but rather that they're not being turned over. In light of the pandemic, however, it is reasonable to wonder how much of that turnover will ever take place. Though it is far too soon to be able to draw any definitive conclusions, we do wonder whether, or at least to what extent, there will still be a desire to move into community settings, as opposed to people simply staying put in their current homes as they hit retirement. To the extent this does prove to be the case, that means less of a support for existing home sales than would have been expected prior to the pandemic.

Another factor we've pointed to as holding down inventories of existing homes for sale is the number of single family homes in the rental segment of the housing market as opposed to being in the for-sale segment of the market. Again, the ACS data have been useful in tracking this pattern, and even though the 2019 ACS data show a modest decline, the share of renter occupied housing units accounted for by single family homes nonetheless remains well above the share that prevailed prior to the 2007-09 recession.



The 2019 ACS data show roughly 14.5 million renter occupied single family housing units, accounting for 32.9 percent of all renter occupied housing units. The share of the renter occupied housing stock accounted for by single family homes peaked in 2014, with just over 15.1 million such units accounting for 35.1 percent of all renter occupied housing units. Keep in mind, though, that this was before the glut of foreclosures left in the wake of the 2007-09 recession had cleared. At the time it was not uncommon for such units to be rented out until they were sold, often at the peril of renters who, with little or no notice, had to move upon the sale of the unit. Still, compare the 2019 figures to those from 2000, when just over 10.6 million renter occupied single family homes accounted for 29.8 percent of all renter occupied housing units. Between 2000 and 2019, the number of renter occupied housing units increased by 23.6 percent, with the number of renter occupied single family units increasing by 36.4 percent.

The wave of foreclosures associated with the 2007-09 recession gave rise to single family REITs making bulk purchases of foreclosed single family homes, finding it feasible to accumulate large numbers within a given metropolitan area. Our view is that this diverted a significant number of single family homes from the for-sale segment of the market. We've often been asked if at some point these institutional owners may begin to sell these properties, but with conditions in the housing market as they are, we don't know what would motivate a significant wave of selling. After all, with rents on single family homes rising at a healthy rate, there is scant evidence of the pandemic impacting rents on single family homes to anywhere near the degree it has impacted rents on apartments in many large metro areas. Moreover, with the pace of house price appreciation picking up even further in recent months, these institutional owners are enjoying the best of both worlds, i.e., steadily increasing cash flows (from rent growth) along with capital appreciation (from house price growth). As such, it would be surprising to see single family REITs go on a selling spree any time soon. Quite to the contrary, we've seen reports that some have built up cash reserves to take advantage of a potential spike in foreclosures as pandemic-related mortgage loan forbearances run their course. This is one reason that, even if there were to be such a spike in foreclosures, we'd expect there to be only a limited impact on house prices.

As a side note, as seen in the prior chart, structures with ten or more units have accounted for a rising share of occupied rental housing units over the past few years, a period which has seen a heavier concentration of such structures within core urban areas. Much of what is the largest backlog of under-construction multi-family housing units since the mid-1970s is concentrated within core urban areas. Even prior to the pandemic, we had been expressing concern over the impact on rents and occupancy rates as more of these under-construction units come on the market. With the fallout from the pandemic diminishing the desirability of core urban areas, those concerns are only amplified.

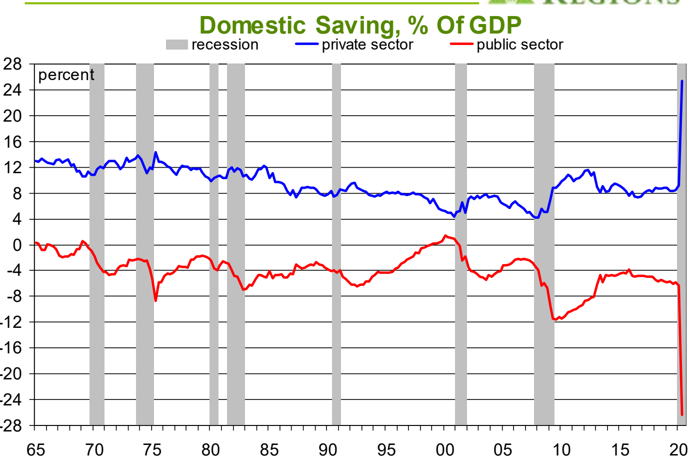
For now, though, we continue to see diminished turnover amongst an aging pool of homeowners and a greater prevalence of single family rental units as weights on inventories of existing homes for sale. While lean inventories don't rule out further increases in existing home sales in the months ahead, they do suggest there is limited upside for sales which, for as long as demand for home purchases holds up, will be a source of upward pressure on house prices. As such, an increasing share of demand for home purchases will be funneled to the new homes market, and while builders face supply constraints of their own, they are nonetheless better positioned to take advantage of growing demand. While it is reasonable to ask whether, or for how long, the recent spike in demand can be sustained, even should this spike subside, that leaves builders back to where they had been for the past several years, i.e., on a path of slow but steady growth in construction and sales of new single family homes. As all of us, particularly homebuilders, know, there are far worse places to be, even if "slow but steady" doesn't generate quite as much buzz as "sizzling."

Domestic Saving To Come Under Increased Pressure

The impact of the financial aid provided to U.S. households under the CARES Act has been the topic of considerable discussion over the past few months. We discussed this topic in both the July and August editions of our *Monthly Economic Outlook*. Such was the magnitude of the surge in transfer payments, mostly in the form of Economic Impact Payments and supplemental Unemployment Insurance benefits, that the personal saving rate shot up to 33.7 percent in April and averaged 25.8 percent for Q2. As was to be expected, the personal saving rate has ebbed over the past few months, falling to 14.1 percent in August.

What has gotten less attention, however, is the flip side of the increase in the personal saving rate, i.e., the increase in dissaving in the government sector, mainly reflecting the significant increase in the federal government budget deficit. To be clear at the outset, which is always important but even more so in the midst of a heated campaign season, this is not intended as a discussion of the merits of the CARES Act nor as an argument on either side of the question of whether or not additional aid is warranted at this point in time. Instead, our point here is a much broader one, and one that we have discussed before, which is the outlook for domestic saving, why it matters, and what some of the potential implications for the broader economy may be. That we do so now simply stems from the recent release of the Federal Reserves *Flow of Funds* report for Q2 2020.

While most discussions of saving focus on personal saving, or, the level of saving in the household sector, total domestic saving also flows from the corporate sector and the government sector. Or not. Any single sector of the economy can engage in dissaving (i.e., run a negative saving rate), as has long been the case in the government sector of the U.S. economy. In a closed economy, negative saving in one or more sectors must be offset by saving in the remaining sector(s), while in an open economy foreign saving can compensate for a lack of, or a persistently low level of, domestic saving. In any economy, closed or open, the aggregate level of investment equals the aggregate level of saving, which matters because, as we've discussed here on numerous occasions, investment is the key fuel of economic growth over time.



Source: Bureau of Economic Analysis; Federal Reserve Board; Regions Economics Division

The chart above shows the paths of private sector saving (or, combined household and corporate saving) and public sector saving, as a percentage of nominal GDP. From the chart, it is easy to see the effects of the CARES Act, referenced earlier, on domestic saving in Q2, i.e., the spike in household saving which pumped up the private sector saving rate even as corporate saving fell sharply, and the offsetting dive in public sector saving. Of the two, the (absolute) decline in public sector saving was larger, such that the domestic saving rate for Q2 fell to -0.97 percent, the lowest domestic saving rate since Q1 2010.

Even prior to the wild swings in Q2, a couple of elements in the data stood out. First, the private sector saving rate was higher in the years following the 2007-09 recession than in the years leading up to that recession. This reflects two things; first a higher personal saving rate, suggesting that for many households the 2007-09 recession led to lasting changes in financial behavior; second, notably strong growth in corporate profits in the years following the 2007-09 recession adding to private sector saving (corporate saving is measured on the basis of net saving, i.e., excluding depreciation). It also stands out that even during the longest economic expansion on record, the degree of government dissaving steadily increased over the past several years.

As for where domestic saving goes from here, the direction seems clear, the timing not so much. The household saving rate will continue to normalize back towards its pre-pandemic level – an average of 5.57 percent of GDP over the 2010-2019 period – though an additional round of aid could push the timing of this normalization back by a few quarters. While not anywhere near as extreme as was the case in Q2 2020, public sector dissaving will almost surely become more pronounced over coming years. As such, coming years will almost surely see persistent declines in the domestic saving rate. To the extent this is the case, that would leave the U.S. with two options. One is to embark on a path of steadily lower investment spending, which implies a lower long-term trend rate of economic growth. The other option is to attract more foreign saving, which over recent decades has bridged the gap between domestic saving and investment.

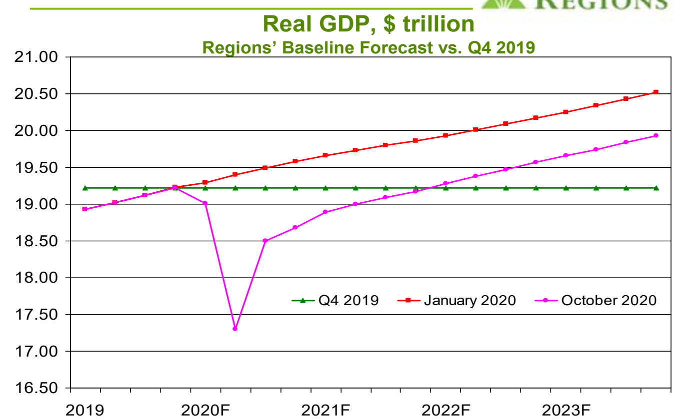
Though not typically thought of or discussed in these terms, the U.S. has consistently run trade deficits over recent decades, and the flip side of this has been a persistent capital inflow, which simply reflects the realities of balance of payments accounting. In other words, the U.S. has basically been able to consistently consume above its means thanks to foreign capital financing the difference. One key reason the U.S. has been able to sustain this dynamic is that the U.S. dollar is effectively the world's reserve currency, and dollars accumulated by foreigners in trade, whether in goods or services, have been "recycled" into demand for assets denominated in U.S. dollars.

That federal government budget deficits figure to become larger over coming years means that, barring an offsetting increase in private sector saving, the U.S. would need to attract even greater sums of foreign savings, and the cost of doing so would almost surely increase. In other words, it would take higher U.S. interest rates to attract increasing amounts of foreign capital, which in turn would pose a challenge to the Federal Reserve, in that it would make it far more difficult for them to influence longer-term market interest rates as a means of supporting economic growth. And, even if the possibility may seem remote at present, there could come a time when there is a viable alternative to the U.S. dollar as the world's reserve currency or, perhaps more likely should global trade become more fragmented, there could be a few different regional reserve currencies. The end result would be the same – a diminished global role for the U.S. dollar would make it harder, and more costly, for the U.S. to attract foreign saving.

This is by no means intended as an alarmist rant. Instead, it is intended as a reminder that the U.S. has been, and remains, highly reliant on foreign capital to finance not only current consumption but also future growth. This can go on, but only until it can't, and that time can come abruptly and without advance notice and bring with it potentially severe adverse consequences.

Charting The Recovery

With full data for July and August and some initial September datapoints now at our disposal, a fuller picture of Q3 GDP is taking form. We now anticipate Q3 real GDP growth of just over 30 percent (the BEA will issue their first estimate on October 29). While that number may seem impressive, keep in mind that it is an annualized growth rate and follows an annualized contraction of 31.4 percent in Q2. As such, even if our forecast of Q3 growth is on the mark, the level of real GDP will still be almost four percent lower than the level as of Q4 2019. From the time it was clear that there would be an epic contraction in real GDP growth in Q2, our benchmark against which to measure the progress in recovering from that contraction would be the level of real GDP as of Q4 2019.



Source: Bureau of Economic Analysis; Regions Economics Division

As of our October baseline forecast, we anticipate the level of real GDP will return to the level as of Q4 2019 in Q1 2022, sooner than anticipated in prior forecasts. This in part reflects our forecast for Q3 growth having gotten progressively higher, reflecting the extent to which much of the high frequency data has surprised to the upside over recent months. Consumer spending on goods, business investment in equipment and machinery, and residential fixed investment surprised to the upside in Q3.

The question isn't whether the pace of growth seen in Q3 can be sustained, obviously it cannot. Instead, the question is the extent to which growth will slow down and how abruptly it will do so, which at this point is very much up in the air. For each driver of Q3 real GDP growth cited above there are reasons for concern, though to a far lesser degree for residential fixed investment than for consumer spending and business investment. Perhaps the biggest area of concern as we move through Q4, however, is the labor market. In addition to the pace of job growth decelerating more rapidly than had been anticipated, the rising duration of unemployment, sagging labor force participation amongst the 25-to-54 year-old age cohort (the "prime working age" population), and looming job cuts as firms adjust to diminished demand all pose hurdles for the economy to overcome on its road to recovery.

Even if it is not particularly pleasant to do so, it is also is worth considering the gap in the level of real GDP between our January and October forecasts. Getting back to the level of real GDP as of Q4 2019 is one thing, but making all of the ground that would have been gained absent the pandemic is a much different proposition.

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Q1 '20 (a)	Q2 '20 (a)	Q3 '20 (f)	Q4 '20 (f)	Q1 '21 (f)	Q2 '21 (f)	Q3 '21 (f)	Q4 '21 (f)		2018 (a)	2019 (a)	2020 (f)	2021 (f)	2022 (f)
-5.0	-31.4	30.8	4.0	4.5	2.2	2.0	1.8	Real GDP[1]	3.0	2.2	-3.8	3.6	2.0
-6.9	-33.2	37.5	2.5	4.7	3.7	1.3	1.8	Real Personal Consumption[1]	2.7	2.4	-4.2	4.0	2.2
-6.7	-27.2	4.3	4.4	6.0	5.9	4.8	4.1	Real Business Fixed Investment[1]	6.9	2.9	-6.4	2.7	3.8
-15.2	-35.9	24.5	9.4	4.8	3.6	2.3	1.3	Equipment[1]	8.0	2.1	-9.4	3.8	1.6
2.4	-11.4	0.2	1.9	6.6	6.6	6.5	7.0	Intellectual Property and Software[1]	7.8	6.4	0.2	3.7	5.8
-3.7	-33.6	-25.5	-2.5	7.6	10.5	7.3	4.9	Structures[1]	3.7	-0.6	-11.9	-2.0	5.1
19.0	-35.6	52.5	13.5	9.0	3.4	2.3	0.2	Real Residential Fixed Investment[1]	-0.6	-1.7	3.9	8.2	0.4
1.3	2.5	8.3	-3.5	-1.3	-1.2	0.2	-0.3	Real Government Expenditures[1]	1.8	2.3	2.6	-0.1	0.0
-788.0	-775.0	-898.0	-922.2	-966.0	-998.0	-993.1	-995.3	Real Net Exports[2]	-877.7	-917.6	-845.8	-988.1	-988.3
968	766	1,009	1,038	1,052	1,056	1,057	1,063	Single Family Housing Starts, ths. of units[3]	872	893	945	1,057	1,073
517	313	433	407	417	408	400	398	Multi-Family Housing Starts, ths. of units[3]	376	403	417	406	385
15.0	11.3	15.5	16.1	15.8	15.9	16.1	16.1	Vehicle Sales, millions of units[3]	17.2	17.0	14.5	16.0	16.2
3.8	13.0	8.8	7.7	7.5	7.2	7.0	6.7	Unemployment Rate, %[4]	3.9	3.7	8.4	7.1	6.2
1.2	-11.2	-6.9	-6.0	-5.2	8.5	3.6	2.7	Non-Farm Employment[5]	1.6	1.4	-5.7	2.2	1.7
2.6	46.6	-20.7	-13.5	30.8	-24.8	-0.4	1.0	Real Disposable Personal Income[1]	3.6	2.2	4.7	-1.9	-0.7
1.8	0.6	1.1	1.2	1.0	2.0	1.5	1.4	GDP Price Deflator[5]	2.4	1.8	1.2	1.5	1.5
1.7	0.6	1.4	1.6	1.4	2.2	1.6	1.4	PCE Deflator[5]	2.1	1.5	1.3	1.6	1.7
2.1	0.4	1.3	1.2	1.3	2.7	1.8	1.6	Consumer Price Index[5]	2.4	1.8	1.3	1.8	1.7
1.8	1.0	1.6	1.8	1.9	2.4	1.8	1.6	Core PCE Deflator[5]	2.0	1.7	1.5	1.9	1.7
2.2	1.3	1.7	1.8	1.8	2.7	2.0	1.8	Core Consumer Price Index[5]	2.1	2.2	1.8	2.1	2.0
1.30	0.13	0.13	0.13	0.13	0.13	0.13	0.13	Fed Funds Target Rate Range Mid-Point, %[4]	1.78	2.16	0.42	0.13	0.13
1.38	0.69	0.65	0.74	0.76	0.81	0.88	0.99	10-Year Treasury Note Yield, %[4]	2.91	2.14	0.86	0.86	1.12
3.52	3.24	2.95	2.94	2.96	3.03	3.12	3.18	30-Year Fixed Mortgage, %[4]	4.54	3.94	3.16	3.07	3.25
-2.1	-3.5	-1.9	-2.2	-2.1	-2.3	-2.2	-2.3	Current Account, % of GDP	-2.2	-2.2	-2.4	-2.2	-2.3

a = actual; f = forecast; p = preliminary

Notes:
1 - annualized percentage change
2 - chained 2012 $ billions
3 - annualized rate
4 - quarterly average
5 - year-over-year percentage change

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